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TAX-BASED INCOMES POLICY (TIP) AS AN ALTERNATIVE TO WAGE AND PRICE CONTROLS

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Traditional theories of fiscal and monetary policy emerged from the decades of the 1970's with a considerable loss of credibility. Until recently, economists and policymakers generally accepted the theory that careful manipulation of fiscal and monetary policy could achieve an acceptable trade-off between inflation and unemployment by balancing aggregate demand and supply. This tenet was first shaken in 1970 when inflation rates did not drop appreciably during a recession. Increased unemployment and substantial amounts of idle capacity did result in some moderation of wage and price demands, but inflation did not fall back to earlier levels.[1] The same phenomenon recurred in the inflationary periods of 1974-75 and 1980. The persistence of inflation in a slack economy posed two significant problems for economic policymakers: (1) unemployment and inflation no longer exhibited a stable inverse relationship, and (2) given levels of employment witnessed increasing rates of inflation.[2]

The government often considers supplementary policies when fiscal and monetary policies fail. Collectively known as "incomes policy," such policies attempt to influence wage and price decisions directly.[3] Experience demonstrates that compulsory wage-price standards, an extreme form of incomes policy, while perhaps effective in achieving at least temporary price restraint,

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[1] *See Annual Report of the Council of Economic Advisors*, in [1981] PRES. ECON. REP. 40 [hereinafter cited as *Economic Report of the President*].

[2] *See generally* Bosworth, *Economic Policy*, in SETTING NATIONAL PRIORITIES, AGENDA FOR THE 1980s (J. Pechman ed. 1980).

[3] Such policies are intended to both control inflation and lower levels of unemployment. Other goals associated with the implementation of incomes policies are (1) breaking the wage-price spiral through dampening of inflationary expectations; (2) alleviating the problems of a wartime economy such as allocation and capacity restraints; and (3) counterbalancing the administration of wages and prices by large economic units. *See* CONGRESSIONAL BUDGET OFFICE, INCOMES POLICIES IN THE UNITED STATES 1 (1977) [hereinafter cited as CBO INCOMES POLICIES].

generally impose unavoidable administrative costs[4] and economic distortions.[5] Recently, economists have suggested using the tax system to reinforce wage and price behavior meeting established criteria. According to its proponents, such "tax-based incomes policy" (TIP) could reduce wage and price increases, thereby lowering inflationary expectations and decelerating the resultant wage-price spiral. Ideally, various groups in society are encouraged to accept lower wages and prices for the goods and services in expectation that the wages and prices they pay will also be lower. At the same time, TIP would impose fewer administrative and economic efficiency costs than wage and price standards. Opponents of TIP, however, consider such proposals to be mere variants of wage and price controls, unjustified by cost-benefit analysis and contrary to a free market economy.

Part I of this article will evaluate the major arguments opposing such policies against the background of the recent American experience with wage and price controls. Part II, in light of the applicability of these arguments to TIPs, will consider whether some variant of TIP could realize the claimed benefits while minimizing the economic and administrative costs usually associated with wage and price controls.

I. WEIGHING THE ARGUMENTS AGAINST INCOMES POLICIES

Incomes policy can take various forms, including "jawboning" (exhortation coupled with adverse publicity for uncooperative firms or employee groups), voluntary wage and price guidelines, and mandatory wage and price controls or freezes. Even though every Administration from World War II through 1980 has used a form of incomes policy to supplement traditional fiscal and monetary measures,[6] critics charge that wage and price controls

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[4] For example, the Council on Wage and Price Stability (CWPS) employed a staff of 42 in 1974 which grew to 238 in 1979. By fiscal year 1981, CWPS had an annual budget of 9.4 million dollars. White House Fact Sheet on Termination of Certain Functions of the Council on Wage and Price Stability (January 29, 1981), *reprinted in* [1981] 5 FED. CONTROLS (BNA) 1051.

[5] Economic distortions may occur in both the product and labor markets. In the product market, controls programs invariably lead to misallocations of resources which may result in artificial scarcities. In the area of labor disputes, wage controls may have a debilitative effect on the "vigor" of the collective bargaining process. *See* G. SHULTZ & K. DAM, ECONOMIC POLICY BEYOND THE HEADLINES 71 (1977).

[6] *See Democratic Study Group Report on Mandatory Wage and Price Controls, reprinted in* [1980] 3 FED. CONTROLS (BNA) 419 [hereinafter cited as *Democratic Study Group Report*].

have no place in an economy based on free enterprise concepts. Their attack focuses on two broad issues of controversy: whether control programs can *ever* be an effective approach to fighting inflation, and the degree to which they impose unavoidable costs on the economy.

A. *Wage-Price Controls as "Quick Fix"*

A central criticism is that controls treat the symptoms of inflation, not the sources, by putting an artificial lid on wages and prices. Controls may in fact exacerbate the problem by building up suppressed demands that explode in worse inflation when the controls are lifted and by diverting attention from the real causes of inflation.[7] To support these arguments, opponents point to the consequences of the two most recent attempts to curb inflation: the mandatory controls of 1971[8] and the voluntary program of 1978.[9] The "new economic policy" of 1971 had

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[7] *Id.* at 422.

[8] With the exception of the controls imposed during 1971-74, mandatory wage and price controls have appeared in the last 40 years only during wartime. Policymakers deemed such measures necessary to ensure allocation of resources to the war effort without risking uncontrolled inflation in consumer markets experiencing shortages. *See id.* at 419.

In 1971, a "new economic policy" attempted to reduce inflation without an accompanying slowing of economic activity which would result in increased unemployment. On August 15, 1971, under authority provided by the Economic Stabilization Act of 1970, 12 U.S.C. § 1904 (1976), the Nixon Administration suddenly announced a 90-day freeze on all wages, prices and profits. The unexpected announcement of controls sought to prevent anticipatory wage and price increases and to break inflation expectations and the consequential wage-price spiral. The purpose behind the 90-day limit on the duration of the freeze was to avoid potential economic distortions and market shortages. The freeze also provided time to establish the administrative apparatus for maintaining the stability of wages and prices. Comprehensive mandatory wage and price controls followed the freeze with the goal of reducing inflation to an annual rate of two to three percent. The Cost of Living Council and a tripartite Pay Board regulated wages and salaries. However, the primary emphasis of the 1971 program was on the control of prices. "Allowable cost" rules permitted price increases in relation to unit cost increases. Thus, the controls regulated prices on a firm-by-firm basis. In addition, a profit margin rule, intended to encourage profit increases through the expansion of sales and productivity rather than through increased prices, controlled prices indirectly. *See* CBO INCOMES POLICIES, *supra* note 3, at 28-43; *Democratic Study Group Report, supra* note 6.

[9] In late 1978, a new anti-inflation program emerged that included explicit but voluntary numerical standards for wage and price increases on an annual basis. Initially, annual increases in wages and private fringe benefit payments had a ceiling of seven percent. The price standard required individual firms to limit their cumulative price increases for certain products over the next year to one half of a percentage point below the firm's average annual rate of price increase during 1976-77, the period selected as being representative of basic underlying cost and productivity trends in individual industries. Firms that could not meet the price "deceleration standard" because of uncontrollable cost increases had to demonstrate that before-tax profit margins were no higher

as its main thrust the direct regulation of prices through a series of complex pricing rules.[10] However, during the period immediately prior to the expiration of the program and for at least a year thereafter, a price explosion occurred. Inflation during this period was greater than it had been at any time since World War II.[11] The voluntary 1978 anti-inflation program, which again attempted direct price control, could not contain the effects of the OPEC oil price increases in 1979. By the time the wage and price program entered its third program year, on September 30, 1980, the Consumer Price Index was well into double figures.[12]

Critics cite these experiences as evidence that controls at best only delay price increases attributable to underlying inflationary forces such as excess demand and external shocks. Incomes policies, by artificially suppressing the true sources of inflation, such as world-wide food shortages, reliance on foreign oil, deficit spending, and declining productivity, eventually result in severe economic distortions and increasing rates of inflation. Therefore, critics deride controls as a simplistic "quick fix" that distracts attention both from the key sources of inflation and from appropriate but more difficult solutions—balancing the federal budget, developing alternative energy sources, and implementing

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than the average of the firm's profit margins during the best two of three fiscal years ending prior to October 1, 1978.

Compliance with the wage and price standards was voluntary in the sense that noncompliance did not result in civil or criminal penalties. At the same time, however, the Administration prepared a list of potential actions that it would take to provide incentives for compliance. Such actions included: (1) a re-examination of various restrictions on import competition in industries in which wage or price increases are exceeding the standards, (2) a request that regulatory agencies evaluate the reasonableness of cost pass-throughs and other rate increase requests in ratemaking proceedings in light of the wage and price standards, (3) an examination of specific markets in which administrative regulations set minimum levels for prices or wages, (4) the publication of companies found to be out of compliance with the wage and price guidelines, and (5) the limitation of government procurement activities to firms that observe the wage and price standards. The Administration hoped that widespread compliance with the wage and price standards would reduce inflation in 1979 to the range of six to six and one-half percent. *See* White House Fact Sheet on President's Anti-Inflation Program (October 24, 1978), *reprinted in* [1981] 5 FED. CONTROLS (BNA) 1001.

[10] *See* note 8 *supra*.

[11] For empirical studies of the controls, see authorities cited in ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, ECONOMIC SURVEYS, UNITED STATES 45 (1980) [hereinafter cited as OECD SURVEY].

[12] By late 1980, many firms and workers perceived the voluntary wage and price guidelines announced in fall 1978 as a failure. This perception was self-fulfilling in the sense that workers and firms were no longer willing to moderate wage and price increases in the expectation that the standards would restrain inflation or in the belief that others would continue to cooperate with the voluntary program. Executive Order No. 12288 issued by President Reagan on January 29, 1981, formally terminated the 1978 voluntary wage and price program. 46 Fed. Reg. 10,135 (1981).

strategies to deal with supply and productivity.

This criticism of wage and price controls is particularly valid insofar as reliance on controls programs leads the federal government to unduly relax its monetary and fiscal policy.[13] Unless a responsible fiscal and monetary policy to reduce excess demand accompanies wage and price control, no controls program can be successful.[14] Such criticism, however, is an insufficient basis to reject completely the use of incomes policies. Rather, policymakers should consider incomes policy as a potentially useful part of a multi-faceted economic strategy to combat economic ills.[15]

Moreover, the recent American experiences with wage and price controls do not lead conclusively to the propositions that the opponents of the controls programs assert. On the contrary, past programs demonstrate that incomes policies do have a significant impact on wage and price expectations and behavior. For example, the mandatory controls imposed during the Korean War are credited with having promoted economic stability for several years after the termination of the program.[16] Also, when a period of relatively high unemployment and price increases in 1962 set the stage for voluntary "guideposts" for wage and price increases,[17] voluntary compliance, supplemented by occasional Presidential jawboning, achieved moderate price and wage increases through 1965.[18] Even the much-maligned 1978 anti-inflation program[19] may have had a positive impact on controls programs on wages and prices, at least during the first two

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[13] G. SHULTZ & K. DAM, *supra* note 5, at 21; *see also* Bosworth, *supra* note 2, at 66-67.

[14] *See* Pechman, *Introduction and Summary,* in SETTING NATIONAL PRIORITIES: AGENDA FOR THE 1980S, *supra* note 2, at 3.

[15] *See* Bosworth, *supra* note 2, at 64-69.

[16] Mandatory wage and price controls imposed in January 1951 followed a sharp increase in the inflation rate after the outbreak of the Korean War in June 1950. Those controls achieved moderate success in dampening inflation associated with the war. Furthermore, the controls did not cause shortages in particular markets or price explosions after the termination of the controls program. *See* CBO INCOMES POLICIES, *supra* note 3, at 10-13.

[17] In conjunction with expansionary monetary and fiscal policies, the guideposts attempted to stimulate production and employment without generating accompanying inflation. The rate of overall productivity increase limited the wage increases in each industry in order to maintain stability of labor costs per unit of output for the economy as a whole. The price guideposts called for: (1) price reduction if the industry's rate of productivity increase exceeded that of the overall economy rate, (2) an increase in price if the rate of productivity increase was less than the overall rate, or (3) stable prices if the two rates of productivity increase were equal. Certain exceptions to the wage and price standards existed for hardship situations and where industries could not attract needed supplies of labor or capital. *See* [1962] PRES. ECON. REP. 189.

[18] *See generally* CBO INCOMES POLICIES, *supra* note 3, at 13-27.

[19] *See* notes 9 and 12 and accompanying text *supra.*

years of the program. In its 1980 Annual Report, the Council on Wage and Price Stability[20] concluded that the standards program had induced considerable pay and price restraint with large attendant social benefits.[21] While this conclusion was the subject of much dispute during the 1980 election campaigns, statistical analyses other than those conducted by the Council suggested that the program had some impact in restraining the acceleration of prices.[22]

Problems with past controls programs can be attributed to a variety of factors not inherent in incomes policies: mistakes in administering and designing the program, economic factors beyond the influence of the domestic economy, and the simultaneous adoption of stimulative fiscal and monetary policy. More fundamentally, however, the causes of the present inflation cannot be attributed to excess demand and an effective policy response requires more than traditional fiscal-monetary restraint to be effective.[23] If now, as in the pre-World War II period, wages and prices were to exhibit a responsiveness to mild recessions, the careful timing of traditional fiscal and monetary policy would result in a deceleration in inflation with only a moderate cost in terms of additional unemployment, lost income, and idle capacity.[24] However, a large degree of inertia, reflected in downward wage and price rigidity, characterizes the current inflation-

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[20] In August 1974, Congress established the Council on Wage and Price Stability to monitor inflationary developments in the economy. Its functions included the review of government and private actions that could impede the supply of materials and goods, educating the public on inflationary situations, publicizing the need for increased productivity, working with management and labor, and gathering data relating to wages and "inflationary factors." The Council on Wage and Price Stability Act, however, made it clear that statutory authority for mandatory controls was not included. 12 U.S.C. §§ 1904-09 (1976). Section 3b of the Act provides "Nothing in this Act . . . authorizes the continuation, imposition, or reimposition of any mandatory economic controls with respect to prices, rents, wages, salaries, corporate dividends, or any similar transfers." Pub. L. No. 93-387, 88 Stat. 750 (1974).

[21] Specifically, studies by the Council on Wage and Price Stability and the Council of Economic Advisors estimated that annual wage increases were one to one and one-half percentage points lower during 1979 than they would have been without the standards, and that the reductions in labor costs had been passed on to consumers through lower price increases. It was estimated that to achieve the same results using fiscal and monetary restraint would have resulted in a one percent increase in the unemployment rate, with an accompanying two percent reduction in output, or $47 billion of lost Gross National Product. *See Economic Report of the President*, *supra* note 1, at 59; COUNCIL ON WAGE AND PRICE STABILITY, ISSUE PAPER, *reprinted in part in* [1980] 3 FED. CONTROLS (BNA) 435, 440 [hereinafter cited as CWPS ISSUE PAPER].

[22] *See* OECD, *supra* note 11, at 46.

[23] For restrictive monetary and fiscal policies to cut the underlying inflation rate by one percent, an estimated one million more persons would have to be unemployed for at least two years. *See* Pechman, *supra* note 14.

[24] *See Economic Report of the President*, *supra* note 1, at 44.

ary period.[25] Thus fiscal and monetary restraint, in order to be effective, must be more stringent than in the pre-World War II period, with greater loss of output and greater unemployment.

This curious momentum in the inflation rate has been attributed to the inflation expectations of business and labor. As inflation increases, the people's expectations of future increases in the inflation rate also rise. These expectations have their basis in opinion, rumor, and speculation rather than in fact.[26] Business and labor raise prices and wages in an effort both to "catch up" with past inflationary increases and to anticipate future increases.[27] In addition, people are less likely to undertake the risky innovative investment necessary to maintain future productivity growth.[28] An effective incomes policy would diminish the self-fulfilling expectations caused by the wage-price spiral. Granted, no monetary, fiscal, or incomes policy, however well designed, can prevent the shocks to the economy from outside sources such as the OPEC oil price increases.[29] Currently such outside supply shocks have the effect of reinforcing the upward momentum of the wage-price spiral.[30] However, if incomes policy were successful in reducing the momentum and rigidity of wage-price expectations, the economy could absorb or "pass-through" such shocks with less effect on the underlying inflation rate.[31]

B. Economic Distortion and Administrative Costs

The second broad issue is the question of the degree to which the imposition of wage and price controls produce unavoidable economic and administrative costs in the economy. Opponents of controls state that interference with the profit motive will force a decline in productivity, create shortages of goods and services in certain markets,[32] and result in a distorted allocation of resources. Such opponents often point to the experiences of World War II and the 1970's when many goods, such as beef,

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[25] *Id.*
[26] *Id.* at 33.
[27] Pechman, *supra* note 14, at 3.
[28] *Economic Report of the President*, *supra* note 1, at 33.
[29] *Id.* at 48.
[30] *See* Bosworth, *supra* note 2, at 39.
[31] *See Economic Report of the President*, *supra* note 1, at 44-45.
[32] Shortages and declines in quality occur when business stops producing items made unprofitable by controls or where greater profits can be made by exporting goods to the uncontrolled foreign market.

were in extremely short supply.[33] Moreover, when profits are controlled, companies may be discouraged from undertaking productivity-enhancing investments making the anti-inflation program counterproductive in the long run.

Critics also claim that controls cause distortion throughout the economy. One example often pointed to is the use of the "base period" concept.[34] This approach to wage and price control, employed with the 1978 standards, sets a certain period of time as the benchmark for gauging wage and price hikes. The problem is that domestic and international economic and business conditions are not constant. Earlier base periods may become inappropriate for certain industries or particular companies. For example, the basic price standard of the 1978 standards did not accommodate the rapid increase of raw material costs (primarily energy) and the consequential acceleration of inflation[35] that occurred shortly after the program was announced.

A "base period" controls program must accommodate the inequities arising for industries or companies that experienced low levels of demand or extraordinary costs during the base period and the concomitant small price increases and/or low profits.[36] In addition, a large bureaucracy[37] is necessary to administer *exceptions* to the general price and wage standards for those entities inequitably affected. This bureaucracy would create inertia to preserve its function and existence, making disengagement from what may have been intended as a temporary controls program more difficult and controversial.[38]

Critics of wage and price controls, however, ignore that the magnitude of economic distortion and related administrative expense under controls programs depend on the economic conditions existing when controls are imposed.[39] During the voluntary

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[33] See CBO INCOMES POLICIES, *supra* note 3, at 43.

[34] *See generally* Kiely & Hunsicker, *Is a Third Year of Pay/Price Standards Necessary?*, Legal Times of Wash., Aug. 11, 1980, at 9, col. 1.

[35] The Council on Wage and Price Stability estimated that seven percentage points of the inflation rate in early 1980 were directly or indirectly attributable to soaring energy prices in 1979. CWPS ISSUE PAPER, *supra* note 21.

[36] *See* G. SHULTZ & K. DAM, *supra* note 5, at 69.

[37] Four thousand workers were employed during the 1970's control period, and federal costs ran to some $125 million annually. *See Democratic Study Group Report, supra* note 6, at 423.

[38] *See* G. SHULTZ & K. DAM, *supra* note 5, at 72.

[39] In a sluggish economy, characterized by high unemployment, low production, and low plant capacity utilization, there is less likelihood of economic distortion. Where business sales are depressed, companies will be less able to cut production or sales of less profitable items to specific domestic markets in an effort to maintain higher profits.

"guideposts" of 1962,[40] for example, economic studies credit the guideposts with restraining price and wage increases prior to 1966, a period during which there was slack in the economy. Only when government spending associated with the Vietnam War and expanded social programs led to increased aggregate demand did the voluntary program become less effective in restraining wage and price increases. By 1967, it became obvious that wage and price guidelines could not restrain inflation while the economy operated at close to full employment and excess demand existed.[41]

The 1970 experience also supports this position, contrary to the assertions of the opponents of controls programs. Arguably, economic distortions during the early 1970's were most acute regarding food. These distortions, however, were primarily the result of substantial demand and world-wide food shortages.[42] In addition, the 1970 controls were in place during a period of rapid economic growth stimulated both by fiscal and monetary policies and by world-wide post-war expansion. In fact, the 1970 controls were intended to accommodate stimulative monetary and fiscal policies deemed necessary to reduce the then existing unemployment rate of six percent.[43]

To summarize, experience with wage and price controls demonstrates that effectiveness depends heavily on existing economic conditions. While controls cannot contain the inflationary wage-price spiral over extended periods without unacceptable cost, experience with both mandatory and voluntary programs indicates that some variant of income policy to reduce present inflationary expectations is an appropriate supplement to traditional fiscal and monetary policy. The conditions of excess demand that both spawned past inflationary periods and overwhelmed past control programs with distortions and shortages do not exist at this time. Rather, present excess industrial capacity, lack of excess demand, and high unemployment could allow the adoption of a flexible incomes policy that would not be accompanied by the economic distortion experienced during the 1970's control period.

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[40] *See* notes 17-18 and accompanying text *supra*.

[41] It has been suggested that this experience reflects the inability of guideposts to prevent inflation in the face of excess aggregate demand. *See* CBO INCOMES POLICIES, *supra* note 3, at 23-27.

[42] *Id.* at 42-46.

[43] *See* OECD SURVEY, *supra* note 11, at 45 (citing ECONOMIC REPORT OF THE PRESIDENT 101-02 (1972) and JOINT ECONOMIC COMMITTEE, PRICE AND WAGE CONTROL: EVALUATION OF A YEAR'S EXPERIENCE (1978)).

II. TAX-BASED INCOMES POLICY IN THE BALANCE

An alternative approach to wage and price controls discussed in recent years is a tax-based incomes policy or TIP.[44] The fundamental rationale of TIP is that aggregate individual wage and price decisions contribute to generalized inflationary pressures. The theory is that by taxing or subsidizing wage and price actions, a TIP could induce less inflationary behavior.[45] Tax rates could be increased for those whose wage or price increases exceeded specified norms, and/or decreased where wage or price decisions reflected the desired degree of restraint.

A. *Variations of the TIP*

Many variants of TIP are possible.[46] Most proposals contemplate the administration of a TIP through the personal or corporate income tax systems, and on an enterprise basis to accommodate changes within a specific company. *Average* rates of wage or price increases within a firm would be evaluated against a target to determine tax penalties or rewards. This formulation allows firms to change the relative pay and prices of workers and specific products. Under this approach, firms could still use merit pay plans and individual pay raises in excess of the target to promote productivity.[47] As noted above, a TIP could impose penalties for wage or price increases above a target, reward increases below a target, or combine the two approaches. The penalty or reward could vary directly with the divergence from the target, or be fixed at a single level depending only upon whether the target or threshold is met. This choice between "reward" and "penalty" TIPs would allow policymakers to focus on employers or employees.

Another variable is the choice between a wage TIP and a price TIP. Government experience with incomes policies suggests that a wage TIP would be easier to administer and would cause fewer

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[44] In recent years, a TIP approach to anti-inflation policy has received increasing attention from economists, policy makers, and the press. *See generally* Seidman, *Tax-Based Incomes Policy*, in CURING CHRONIC INFLATION 65, 67 (A. Okun & G. Perry eds. 1978). Had the Carter Administration won re-election in 1980, some form of TIP may well have been proposed. *See Economic Report of the President*, *supra* note 1, at 67-68.

[45] For the case against use of the Internal Revenue Service as the administrative apparatus for TIPs, see G. SHULTZ & K. DAM, *supra* note 5, at 83-84.

[46] *See generally* Seidman, *supra* note 44, at 67.

[47] *See Economic Report of the President*, *supra* note 1, at 60.

economic distortions than a price TIP.[48] As with all price standards, establishing price targets for various firms raises problems of defining prices, accommodating new products and quality changes in old products, and dealing with the inequities caused by defining allowable prices in terms of a base period.[49] If the theoretical and empirical evidence suggesting that price inflation will decline automatically when wage inflation declines is correct,[50] a price TIP would be unnecessary.

Because a penalty wage TIP or a reward wage TIP can provide the same TIP incentive effect, the choice among a penalty or a reward or a combination thereof[51] depends on (1) the anticipated effectiveness of each type of TIP and (2) the ever-present administrative concerns. Arguably, an employee reward TIP would encourage workers to cooperate with a voluntary incomes policy by compensating them for accepting lower pay increases,[52] and enhance effectiveness. An employer penalty TIP, on the other hand, would rely on employers' responsiveness to tax penalties rather than employees' responsiveness to tax rewards. This penalty aspect may be essential to a high probability of effectiveness, and would also bolster government revenues in the process. Moreover, a TIP that penalized firms for excessive pay increases could reasonably be limited to relatively large firms, thus limiting the administrative burdens to companies best equipped to handle them.[53]

Despite the merits of each proposal considered alone, combining the employee reward TIP with an employer penalty wage TIP has additional advantages. Worker incentives could be adopted to accompany an employer penalty TIP,[54] combining the attributes of both approaches.[55]

A third variable is whether a TIP should apply continuously,

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[48] *See id.* at 65.

[49] *See generally* Kiely & Hunsicker, *supra* note 34.

[50] *See* note 59 *infra*.

[51] *See* Seidman, *supra* note 44, at 71.

[52] *See Economic Report of the President*, *supra* note 1, at 63.

[53] *See* Dildine & Sunley, *Administrative Problems of Tax-Based Incomes Policies*, in CURING CHRONIC INFLATION 151 (A. Okun & G. Perry eds. 1978). Limiting the TIP to firms with more than 100 employees would cover more than 60% of total employment, but would eliminate 99% of businesses from the associated record keeping, reporting and auditing requirements.

[54] *See Economic Report of the President*, *supra* note 1, at 61.

[55] For example, a firm granting a wage increase in excess of the target wage inflation rate could be surcharged on its income tax in proportion to the excess. Wage increases less than this amount could be rewarded with proportionate tax cuts. Tax increases or cuts could be applied to the employees of firms granting increases above or below the target in order to provide an employee incentive. *Id.* at 60.

or only when a performance threshold is crossed. Under a continuous penalty TIP, tax rates vary directly with the degree of divergence from the wage target. Thus, a continuous TIP could provide constant incentives for wage restraint. A threshold approach would mean that exact increases in wages would not have to be tracked for every firm, leading to greater administrative efficiency. Internal Revenue Service audits, for example, could be restricted to firms near the threshold.[56] A threshold TIP, however, provides little incentive for a firm to approach the threshold target if the target cannot be met, or to practice further pay restraint once the target is reached. Therefore, a continuous TIP may be more effective than a threshold TIP because only the former provides incentives to lower *all* pay increases. In addition, a continuous TIP could be less disruptive of the existing pattern of relative wages because a continuous TIP should exert similar downward pressure on all pay changes.[57]

B. *TIP Versus Traditional Controls*

Wage and price decisions are clearly a key element in the momentum of the inflationary process. Both traditional controls and tax-based incomes policies attempt to thwart inflation by affecting these decisions. On balance, the use of financial incentives — direct inducements by a reward TIP and disincentives by a penalty TIP — seem more likely to be effective than a controls program involving a high degree of government participation. In addition, a TIP would permit more flexible adjustments between companies and sectors than either voluntary or mandatory controls could achieve.

The ultimate goal of a TIP, of course, would be to control the rate of *price* increases. The greatest advantage that TIP may have over wage and price controls is the possibility that TIP could achieve this goal by restricting increases in *wages*.[58] A TIP could reward or penalize employers or employees for wage behavior, without including specific standards for price behavior. Thus a TIP could avoid the greatest problems associated with past control programs: difficulties in defining allowable price or profit increases, the administrative problems of monitoring actual behavior, and the economic distortions and inefficiencies

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[56] *See id.* at 62-63.
[57] *See* Seidman, *supra* note 44, at 97-99.
[58] *Id.* at 73, 84-90.

that accompany imposed price and profit limits. Price inflation reduction could be achieved if macroeconomists are correct in forecasting that price increases, two-thirds of which purportedly reflect labor costs, will decline automatically with restrained wage increases.[59] Theoretically, price restraints would follow closely on the heels of initial wage slowdowns. This initial slowdown coupled with the perception of TIP as an effective anti-inflation program would favorably influence the inflationary expectations of workers.[60] In a reversal of the wage-price spiral, decelerating prices and expectations thereof would result in additional wage restraint in the second year after the enactment of TIP and further deceleration of prices.

CONCLUSION

As inflation has become less sensitive to induced reductions to aggregate demand, the traditional anti-inflation policy tools of fiscal and monetary restraint have become less effective and more costly in terms of lost output and higher unemployment. As a result, economic policymaking has faced the critical challenge of reducing inflation while maintaining a prosperous and

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[59] *See* Gordon, *Can the Inflation of the 1970s be Explained?*, 1977 BROOKINGS PAPERS ON ECON. ACTIVITY 253. According to this theory, most prices (other than those of raw materials and agricultural products) are directly related to variable costs of production of which the largest are labor related. Given wages, prices are relatively insensitive to variations.

If correct, this approach would not affect the relative distribution of income shares between wages and profits because prices would fully reflect the changes in wages encouraged by TIP. This conclusion assumes that TIP will not affect existing, relative market power in the economy.

Convincing labor of this relationship to assure cooperation would be critical to the adoption and viability of the program. A program of "real wage insurance" as was proposed in 1978 for those who had observed the wage standard would encourage labor to support the program. This program, which was not adopted, sought to provide tax refunds to members of employee groups that complied with the seven percent wage standard if the Consumer Price Index increased by more than seven percent over the year. White House Fact Sheet on President's Anti-Inflation Program, *supra* note 9. In addition to "real wage insurance," tax cuts for workers in the event that price inflation exceeds wage inflation and a special tax surcharge on corporate profits that increase excessively relative to wages are alternative possibilities. *See id.*; Okun, *Incomes Inflation and the Policy Alternatives*, in THE ECONOMISTS CONFERENCE ON INFLATION, 1 REPORT 365 (1974); Klein & Duggal, *Guidelines in Economic Stabilization: A New Consideration*, 6 WHARTON Q. 20-24 (1971). Whatever option may be deemed necessary, to authorize the labor protection at the same time TIP is enacted would be important to guarantee protection in advance, and to encourage cooperation.

[60] *See* Perry, *Slowing the Wage-Price Spiral*, in CURING CHRONIC INFLATION 50 (A. Okun & G. Perry eds. 1978).

growing economy. Incomes policies may present a useful *supplement* to monetary and fiscal restraint. By encouraging groups to accept lower wages and prices in the expectation of reduced inflation, incomes policies reduce the cost of lost output and employment that result from any given level of demand restraint.

Incomes policies also impose administrative and economic efficiency costs, however. These costs tend to be highest where a rigid form of incomes policies, mandatory wage and price controls, is employed. These costs can be reduced, if not eliminated, by encouraging wage restraint and associated price restraint, through the use of tax surcharges and/or rewards.

The administrative and efficiency costs associated with formal incomes policies tend to grow over time. For this reason, the costs of a permanent TIP may exceed its anti-inflationary benefit at some point. A temporary TIP, however, would impose relatively small costs at the outset of the program and, if successful in winding down the wage-price spiral, is worthy of serious consideration as a complement to fiscal and monetary demand restraint.